Supreme Court, U.S.
FILED
FEB 28 1986
JOSEPH F. SPANIOL, JR.
CLERK

NO. 85-554

IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

UNITED STATES OF AMERICA,
Petitioner,

v.

HUGHES PROPERTIES, INC.,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

BRIEF FOR RESPONDENT HUGHES PROPERTIES, INC.

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QUESTION PRESENTED

Whether the Federal Circuit correctly determined the proper time for deduction by an accrual basis taxpayer engaged in the business of gaming of an expense represented by its unpaid liability for progressive slot machine jackpots.

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BRIEF FOR RESPONDENT HUGHES PROPERTIES, INC.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved in this case that are not set forth in the statutory appendix to the Petition for Certiorari are Section 1.446-1(c)(1)(ii) of the Treasury Regulations on Income Tax (26 C.F.R.), Section 463.310 of the Nevada Revised Statutes and Section 5.110 of the Nevada Gaming Regulations. These provisions are included in the appendix to Respondent's Brief in Opposition to Petition for Writ of Certiorari (Resp.

App. 1a-5a). Section 463.310 of the Nevada Revised Statutes and Section 5.110 of the Nevada Gaming Regulations are reprinted at J. A. 53-57.

STATEMENT OF THE CASE

This statement of the case is necessitated by deficiences in that of the United States (the "government"). Additional matters which were relevant to the courts below and which respondent, Hughes Properties, Inc. ("HPI"), believes must be considered by the Court are:

1. During the taxable years in issue, HPI owned and operated various types of slot machines which paid progressive, or "guaranteed," jackpots. These machines had different features which bore on the frequency of their payment of guaranteed jackpots (Pet. App. 6a-7a). Guaranteed jackpots are determined at random and not by a predetermined number of plays (Pet. Br. 26). The average period between HPI's payoffs on its progressive slot machines' guaranteed jackpots was approximately 4½ months (Pet. App. 6a-7a; Pet. Br. 26). All of HPI's accrued but unpaid guaranteed jackpots as of the close of the last taxable year in issue, June 30, 1977, were subsequently won by and paid to customers of HPI (J. A. 62).

2. The Nevada Gaming Commission (the "Commission"), which promulgated § 5.110 of the Nevada Gaming Regulations ("Regulations"), and the Nevada Gaming Control Board (the "Board") strictly enforce Regulation § 5.110 and the policies implementing such Regulation. Section 463.310 of the Nevada Revised Statutes ("N.R.S.") authorizes the Commission to impose severe sanctions (including revocation or suspension of gaming licenses and fines up to $100,000) on any licensed gaming establishment that wrongfully refuses to pay a

winning customer a guaranteed jackpot. A guaranteed jackpot cannot be reduced or eliminated except by the winning of such jackpot (Pet. App. 9a).

3. For its taxable years ending June 30, 1973, through June 30, 1977, the gross operating income of HPI's casino, Harolds Club, from its gaming transactions, after deducting all amounts won by customers in gaming transactions, but prior to the deduction of the accrued progressive slot machine liability, and the net income of HPI from all of its activities, after deducting all expenses except the guaranteed jackpot liabilities in issue, were as follows:

Taxable Years Ending June 30	Gross Operating Income From Gaming	Net Income From All Activities
1973	$20,367,609	$4,836,429
1974	20,859,135	5,512,863
1975	21,133,604	4,616,157
1976	23,299,066	6,001,156
1977	23,571,332	5,896,078

(J. A. 35-36).

4. The meter readings on HPI's progressive slot machines provided it the numerical data for the deductions in issue. The accrued but unpaid guaranteed jackpot amounts as recorded by HPI from 1973 to 1977 were:

Fiscal Year Ended June 30	Accrued Liability	Deduction (Income)
1973	$360,228.55	$360,228.55
1974	563,983.99	203,755.44
1975	853,584.22	289,600,23
1976	839,400.97	(14,183.25)
1977	888,820.67	49,419.70

(Pet. App. 9a).

5. HPI deducted as an ordinary and necessary business expense under Section 162 of the Code[1] the net accrued liability for guaranteed jackpots for each fiscal year. Such net accrued liability was determined by subtracting the previous year's accrued liability, which had already been deducted, from the current gross liability as indicated by the meter totals. For example, at midnight on the last day of fiscal year 1974, HPI recorded the meter readings on its progressive slot machines, its accountants totalled the amounts so recorded and determined that HPI's gross year-end liability for that fiscal year was $563,983.99. Because HPI had already deducted $360,228.55 as a business expense in the previous fiscal year, the net accrued liability for 1974 was determined to be $203,755.44. This is the amount that HPI reported as a deduction on its income tax return for fiscal year 1974 (Pet. App. 10a).

6. Although there is no dispute as to the accuracy of the amounts deducted by HPI, the Internal Revenue Service claimed that the guaranteed jackpot payoffs could only be deducted in the year actually paid because the guaranteed jackpot amounts were merely a contingent liability and determined an aggregate deficiency in HPI's income tax, which it paid and for which it sought a refund, in the amount of $433,441.88 for its four taxable years in issue (Pet. App. 1a, 10a).

7. HPI's primary contention to the Claims Court was that the accrued expense deductions were timely because the liability for the guaranteed jackpots was fixed by Nevada law (Pet. App. 12a). The case was decided in the Claims

1. Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as amended and as in effect for the tax years at issue (the "Code").

Court on cross motions for summary judgment. The only evidence offered by the government in support of its motion for summary judgment was an affidavit from its counsel adopting and stipulating factual contentions contained in HPI's pretrial submission (J. A. 15-46) (Pet. Br. 2). Among these stipulated facts was the fact that the guaranteed jackpots constituted a fixed liability for which payment could not be avoided because of Gaming Regulation § 5.110. (J. A. 15-16, 42). The Claims Court stated in its opinion that "[The government] specifically rejects [HPI's] argument that the jackpot liability was fixed *despite admitting that [HPI] is precluded from avoiding payment as a result of Nevada Gaming Commission Regulation § 5.110.*" (Pet. App. 12a) (emphasis added). The Claims Court, in sustaining HPI's position, noted that the government "does not contest the deductibility per se of [HPI's] liability for the guaranteed jackpot amounts, but rather takes issue with the timing of those deductions." (Pet. App. 11a) (original quotation marks omitted). The Claims Court held:

> [A]t the end of [HPI's] fiscal year, [HPI's] obligation to pay out the recorded amount is "unconditionally fixed" by the terms of § 5.110. Under that regulation, the liability for the jackpot amount can be enforced by the Nevada Gaming Commission. . . . That the identity of that "fortunate gambler" is unknown, that the exact time the jackpot will be won is unknown, or that the exact amount of the jackpot at the time it is won is unknown does not affect the certainty of the liability at the end of [HPI's] fiscal year. . . . In the fact setting before the court, the uncertainties listed above do not destroy the initial certainty of liability.

(Pet. App. 14a).

The Claims Court acknowledged that it "will not hesitate to uphold the Commissioner's efforts to eradicate fraudulent practices, but, where no such practice has been alleged or proven and where the court has found that the timing of the deduction does not distort income, the court will not act on mere speculation." (Pet. App. 17a). The Claims Court held that "the liability is *unconditionally fixed* by § 463.310 of the Nevada Revised Statutes which gives full force and effect to Nevada Gaming Regulation § 5.110." (Pet. App. 18a-19a) (emphasis in original). The court "respectfully declined to follow" the Ninth Circuit's contrary decision in *Nightingale v. United States*, 684 F.2d 611 (9th Cir. 1982) (Pet. App. 15a). The Claims Court observed that the Ninth Circuit in *Nightingale* misstated the consequences of a casino's going out of business, noting that from a federal income tax perspective, such event would result in the casino having to recapture its previous deductions as income. (Pet. App. 15a).

8. The Federal Circuit concluded that the trial judge had "carefully examined all of the arguments raised on the present appeal." (Pet. App. 3a). The Court of Appeals "re-examined those arguments, the briefs, statutes, regulations, and authorities and conclude[d] that the [Claims Court] was legally correct when it granted summary judgment to the taxpayer." (Pet. App. 3a). The Federal Circuit acknowledged that the Claims Court had "declined to follow the contrary conclusion of the Ninth Circuit" in *Nightingale* (Pet. App. 2a).

SUMMARY OF ARGUMENT

There is no disagreement that progressive slot machine jackpots are ordinary and necessary business expenses and are deductible under Section 162. The issue before the Court, one which is fundamental to federal income

tax accounting, is the proper *time* for the allowance of such deductions by a taxpayer which has adopted the accrual method of accounting. Determinative of this question is the application of the so called "all events" test, which was first articulated in *United States v. Anderson*, 269 U.S. 422 (1926), and subsequently incorporated in Treasury Regulation § 1.461-1(a)(2). That test dictates that an expense is incurred, and thus properly accrues, for federal income tax purposes *at the time* when the *events* establishing the *fact of liability* for the expense have occurred. Again, there seems to be no disagreement between the government and HPI that it is the application of this principle which governs the disposition of this case. The difference of opinion between the government and HPI, which this Court has been petitioned by the government to resolve, relates to the event which establishes HPI's liability for its guaranteed jackpots and thus the timing of its deduction therefor.

HPI contends, and the Federal Circuit and the Claims Court concur, that the fact of liability for the guaranteed jackpots resulted from HPI's operation of progressive slot machines on its casino floor. Because HPI's obligation to pay the amount of guaranteed jackpots registered on such machines' payoff indicators is unconditionally fixed under applicable Nevada law once such machines are placed in operation, and cannot thereafter be effectively avoided, HPI's accrual of deductions for such liabilities, based on the amounts registered on the payoff indicators at its year end, was proper under federal income tax accounting principles. The government contends that such obligations may be properly accrued only at the time the guaranteed jackpot is won. The position of HPI, the Claims Court, and the Federal Circuit are strongly supported by an extensive body of judicial authority. The government has no support in fact or in law for its position.

ARGUMENT

THE CLAIMS COURT AND THE FEDERAL CIRCUIT CORRECTLY DETERMINED THAT AN ACCRUAL BASIS TAXPAYER ENGAGED IN THE BUSINESS OF GAMING PROPERLY DEDUCTED FOR FEDERAL INCOME TAX PURPOSES ITS ACCRUED LIABILITY FOR GUARANTEED JACKPOTS.

A. Nevada Law Fixes HPI's Liability.

The obligation to pay guaranteed jackpots is established at the time progressive slot machines are placed in operation and at all times thereafter by the Regulations promulgated pursuant to Nevada statutory authority and the policies implementing such Regulations. The Regulations, as implemented by the policies of the Commission and the Board, are binding on all licensed gaming establishments in the State of Nevada. Under Nevada law, the Commission regulates the activities of licensed gaming establishments through its Regulations and policies, and the Board has the authority to enforce these Regulations and policies. A paramount purpose of such Regulations and policies is to protect the interests of the gaming public and to preserve the integrity of the gaming industry in Nevada. N.R.S. §§ 463.140 & 463.0129 (1955).

In September 1972, pursuant to N.R.S. §§ 463 and 463B, the Commission promulgated Regulation § 5.110 which regulates the operators of progressive slot machines. Regulation § 5.110 was effective for all times relevant to the taxable years in issue in this case. Such Regulation precludes a licensed gaming establishment from avoiding payment of its liability for guaranteed jackpots. Under the Regulation, the amount of the liability may not be reduced until the guaranteed jackpot is paid. To insure

payment, licensees are required to maintain minimum cash balances equal to the total of all guaranteed jackpots offered by its machines. Consequently, the Regulation makes the liability for guaranteed jackpots fixed and unconditional from the time a machine is introduced on the casino floor and at all times thereafter.

The undisputed facts establish that the liability for guaranteed jackpots cannot be avoided. Regulation § 5.110 expressly mandates that the payoff indicator for the machines cannot be turned back. The removal of a progressive slot machine from the casino floor, the repair and maintenance of a machine, the conversion of the licensee's form of business organization, or the sale or other disposition of the licensee's business will not result in the licensee being directly or indirectly relieved of its obligation (J. A. 59, 63-64, 73-75, 78). Severe sanctions are applicable to licensees (including fines, but more importantly, revocation or suspension of its license to do business) for attempting to avoid payment of a guaranteed jackpot, or otherwise violating the Commission's Regulations and the policies of the Commission and the Board (N.R.S. § 463.310; J. A. 59, 71-72, 77). It is these Regulations, statutes, and policies which *unconditionally* fixed HPI's liability for the guaranteed jackpots prior to their being won by a customer. It is this liability which required HPI to accrue the liability at year end for federal income tax purposes. HPI had no discretion in the matter. It could not have deferred the deductions even if it had chosen to do so. For example, if HPI anticipated significant income in the succeeding year which the deductions would reduce, it could not have properly deferred the deductions to that year.

Although HPI's machines are mechanically capable of being set at odds which might theoretically suggest that

the chances of a jackpot being won are remote, the average time of payment of HPI's guaranteed jackpots was determined to be approximately 4½ months (Pet. App. 6a-7a). Such statistic is a reflection of the competitive pressures which demand that realistic payoff opportunities be offered to the gaming public and the random occurrence of winning combinations of symbols resulting in jackpots. The determination was made as of September 1, 1976, for the twenty-four (24) four-reel progressive slot machines then in operation. All but two of these machines were installed prior to 1974 (J. A. 62). Although HPI also operated a number of three-reel machines during this period, its payoff experience with respect to these machines was not taken into account in such determination. Because of the fewer number of reels, these machines produce more frequent jackpots than their four-reel counterparts (J. A. 62). All of the accrued but unpaid jackpots utilized by HPI to determine its deductions for the years in issue were actually won by and paid to customers of HPI (J. A. 62).

Anderson, 269 U.S. 422, is the source of the principle that an intervening requirement which serves as a predicate to *fixing the time of payment* of a liability (rather than fixing the liability) does not postpone its accrual for federal income tax purposes. In *Anderson,* the issue was the propriety of the accrual of a munitions tax prior to its assessment. Although such assessment was required before the tax became due, the absence of the assessment did not prevent accrual of the tax.[2] Likewise, in *Continental Tie & Lumber Co. v. United States,* 286 U.S. 290, 295-98 (1932), accrual of a yet-to-be made award

2. It is noteworthy that the government's position in *Anderson,* that the tax liability accrued before assessment, is diametrically opposed to its position in this case.

in an undetermined amount under a newly enacted statute was held proper.

These authorities do not stand alone. Numerous other cases have adopted the principle that the absence of a future event required as a condition to payment of a liability does not render the liability contingent and thus not properly accruable for federal income tax purposes, *e.g., American National Co. v. United States,* 274 U.S. 99 (1927); *Kaiser Steel Corp. v. United States,* 717 F.2d 1304 (9th Cir. 1983); *Crescent Wharf & Warehouse Co. v. Commissioner,* 518 F.2d 772 (9th Cir. 1975), *rev'g* 59 T.C. 751 (1973); *Pacific Grape Products Co. v. Commissioner,* 219 F.2d 862 (9th Cir. 1955), *rev'g* 17 T.C. 1097 (1952). Accordingly, under the well founded principles of *Anderson,* the fact that the "winning handle pull determining the fortunate gambler" to whom a guaranteed jackpot would be paid had not occurred at the end of HPI's taxable year does not preclude HPI from taking such liability into account in determining its taxable income for such year but, to the contrary, requires that it do so.

B. The Federal Circuit's Decision Is Strongly Supported By Analogous Authorities.

The most analogous authorities determining the treatment of guaranteed jackpots as accrued liabilities under the all events test are a series of cases involving strip mining operations. In those cases, the cost of satisfying an obligation imposed by state law has been held properly accruable upon the happening of the events giving rise to such obligation, not when the event fixing the time of performance of such obligation occurs. *Harrold v. Commissioner,* 192 F.2d 1002 (4th Cir. 1951). *See also Denise Coal Co. v. Commissioner,* 271 F.2d 930 (3d Cir. 1959);

Ohio River Collieries Co. v. Commissioner, 77 T.C. 1369 (1981).

These cases address the question of whether the estimated costs of restoring stripped land to its former condition may be properly accrued at the time mining occurs or at some then undetermined future date when the costs to restore the land are incurred. These cases hold that it is proper to accrue the restoration expenses at the time the mining occurs despite, as is the case here, there being no specifically identifiable obligee to whom the costs are owed at the time and the time when such costs would be paid being uncertain.

The rationale of the strip mining cases has been followed in other contexts. *Gillis v. United States*, 402 F.2d 501 (5th Cir. 1968) (obligation for anticipated claims resulting from shipping defective cotton); *Schuessler v. Commissioner*, 230 F.2d 722 (5th Cir. 1956) (obligation to turn furnaces on and off at undetermined times); *Pacific Grape Products Co.*, 219 F.2d 862 (future obligation to package and ship products previously sold).

The reason the mining cases and their progeny are so closely analogous to the situation at hand is readily apparent when those cases are compared to this case:

	Mining Cases	*HPI's Case*
Nature of obligation:	Imposed by state law	Imposed by state law
Event establishing fact of liability:	Conducting mining operations	Operating the progressive slot machines
Event establishing time of payment and identity of specific payee:	Contractor's performing backfilling	Customer's winning the guaranteed jackpot

Here, as in the mining cases, the accruals are properly allowable in the taxable years in which the deductions were taken because all events resulting in the liabilities giving rise to the deductions had occurred in those years even though the identity of the payee of such liabilities and the time of payment had not then been determined.

The purpose of the all events test is to insure that no deduction is accrued which will not ultimately be borne in an economic sense. It is clear that accrual of the guaranteed jackpots is entirely consistent with this purpose. Any other conclusion would conflict with a long established body of law.

C. The Government's Position Is Devoid Of Support.

1. The government, in its zeal to enhance the fisc, urges on the Court a result which defers accrual of a clearly allowable expense until the event occurs that requires that the liability giving rise to such expense be satisfied—"a winning pull of the slot machine handle"—not when the fact of liability has been determined (Pet. Br. 13). In support of such result, the government contends that because Gaming Regulation § 5.110 does not expressly require HPI to pay a guaranteed jackpot unless and until it is won, that Regulation creates only what the government sometimes refers to as a "potential" liability and sometimes as a "contingent" liability, neither of which supports the accrual of an expense (Pet. Br. 15-16). The government contends this must necessarily be so because to hold otherwise would ignore the impact of this Court's decision in *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979), or lead to abusive situations for which no remedy might otherwise exist (Pet. Br. 24-28, 30-32).

The government, in its analysis of Regulation § 5.110, ignores the Commission's underlying policies and, in particular, N.R.S. § 463.310 which subjects HPI to extreme sanctions if it fails to pay a winning gambler. The result it seeks is in direct conflict with a long-standing body of existing law. *Anderson*, 269 U.S. 422; *Denise Coal Co.*, 271 F.2d 930; *Pacific Grape Products Co.*, 219 F.2d 862; *Harrold*, 192 F.2d 1002; *Ohio River Collieries Co.*, 77 T.C. 1369.

The government's principal argument—that no accrual is proper in this case until "the winning of the progressive jackpot by some fortunate gambler"—is based on the Ninth Circuit's analysis in *Nightingale* (Pet. Br. 13). The court in *Nightingale* erroneously concluded that because the time of payment and the identity of the winning gambler were uncertain that the liability in that case for guaranteed jackpots was contingent. *Nightingale*, 684 F.2d at 614. What neither the court in *Nightingale* nor the government here recognizes is that such an analysis ignores, and is in conflict with, well-settled case law which holds that the uncertainty of the time for payment of a liability or the inability to identify the payee of such liability will not prevent the accrual of the underlying expense represented by such liability. *Lukens Steel Co. v. Commissioner*, 442 F.2d 1131 (3d Cir. 1971), *aff'g* 52 T.C. 764 (1969); *Denise Coal Co.* 271 F.2d 930; *Harrold*, 192 F.2d 1002; *Cyclops Corp. v. United States*, 408 F. Supp. 1287 (W.D. Pa. 1976); *Inland Steel Co. v. United States*, 76-2 U.S. Tax Cas. (CCH) ¶ 9791 (Ct. Cl. 1976); *Washington Post Co. v. United States*, 405 F.2d 1279 (Ct. Cl. 1969); *Ohio River Collieries Co.*, 77 T.C. 1369.

Although it is obvious that winning the jackpot necessarily identifies the specific person entitled to payment, that event does not determine the fact of liability for such jackpot. That fact was previously determined by HPI's introduction and operation of the progressive slot machines on the casino floor. At the time the guaranteed jackpots were won, all of the facts determining HPI's liability therefor had previously occurred. HPI's accrual of the guaranteed jackpots is consistent with the decisions in *Lukens Steel*, *Harrold*, and *Washington Post*. HPI had irrevocably committed to pay the liability for the guaranteed jackpots. Such liability could not be avoided. The only unknowns at year end were the time payment would be made and the identity of the winning customer. The Claims Court and the Federal Circuit correctly rejected the government's argument and *Nightingale's* holding that deductibility was precluded by such unknown facts (Pet. App. 2a, 14a).

Even if the government's assertion that there can be no "unconditional liability" unless there exists some person or entity to whom the taxpayer is liable (Pet. Br. 31) were accepted, there is no absence of obligees in this case. The Nevada gaming laws, in general, and the cited Regulation, in particular, were designed to insure HPI's unconditional liability to the gaming public pending determination of the member of that class to whom the jackpot would be paid. The Gaming Commission and Board have been delegated the responsibility of enforcing the liability until such time. Such a characterization is entirely consistent with the nature of the obligees in the strip mining cases—the general population of the states in which the strip mining occurred.

The government's rejection of Regulation § 5.110 as the basis for HPI's accrual ignores that the combination of the policies of the Board and the Commission and the statutory sanctions enforcing such Regulation served to insure that HPI's liability for the guaranteed jackpots was an economic certainty. HPI's payoff experience, alone, serves to emphasize this fact. The government's contention that such Regulation does no more than "to place a floor beneath the *amount* of [HPI's] *potential* liability" and indicates only "the minimum amount that a future patron will win" (Pet. Br. 16) (emphasis in original) is consistent with its refusal to recognize that such a liability then exists. This contention, however, fails to consider the random manner in which the winning combination of symbols determining a guaranteed jackpot occur. Potentially, at any point in time, the next play of the machine will produce a guaranteed jackpot in the amount shown on the machine's meter. Thus immediately prior to each play, the government's "future patron" and the exact amount of the guaranteed jackpot (not the minimum) which may be won by such patron is known. Because of the random manner by which guaranteed jackpots will occur, a coin played in any of HPI's progressive slot machines at 12:01 a.m. on July 1, the commencement of its fiscal year, might well yield a guaranteed jackpot in the amount shown on the meter at that time. The government, in its analysis, has completely missed this point.

2. The government argues that the guaranteed jackpots may represent a *probable* liability of HPI which would only "likely" or "eventually" be incurred but that such probability was at best remote and subject to indefinite deferral by HPI (Pet. Br. 13-14). These observations are inaccurate and misleading in that they ignore

that payments of guaranteed jackpots occur, not by a predetermined number of plays, but at random, and thus are not within the discretion or practical control of a licensee. Such contentions further ignore that industry competition demands that realistic chances to win the guaranteed jackpots be offered to the gaming public. As previously noted, the average time for payout of HPI's guaranteed jackpots was 4½ months (J. A. 62). Accrued guaranteed jackpot expense accounted for less than 1% of HPI's gaming revenue for the years in question (J. A. 35-36; Pet. App. 9a). Such facts certainly offer no support to the government's "remoteness" theory but, to the contrary, emphasize the reality of the obligation. The lack of materiality of the guaranteed jackpot expense in the context of HPI's overall financial condition emphasizes the lack of any motivation on HPI's part to unrealistically defer this payment. As the government concedes, there is no evidence in the record which even intimates that HPI engaged in any such manipulative practice nor has the government so contended. In view of the strip mining cases where the taxpayer had theoretical control over the timing of its abandonment of a mine, thus causing its restoration obligation to mature, the government's erroneous implications regarding the remoteness of the guaranteed jackpots are irrelevant in any event.

In *Mooney Aircraft, Inc. v. United States,* 420 F.2d 400 (5th Cir. 1969), the deduction of an accrued expense which was incurred upon the sale of an airplane but which was not payable until such airplane was retired from service was denied because of the twenty to thirty year interval between the accrual and its payment. Here, the accrued expenses were, in general, paid within 4½ months. Notably, in *Mooney,* accural of the expense was found to satisfy the all events test because, as is the case here, the

fact of the liability was certain, the deduction being disallowed on other grounds.

3. The government observes, as did the court in *Nightingale*, that HPI could avoid the liability for the guaranteed jackpots by going out of business (Pet. Br. 14). The court in *Nightingale* used such observation not as a basis for, but only to support, its holding. Properly, the government draws no express conclusion from this observation. Clearly, speculative possibilities, even theoretically voluntary alternatives such as going out of business, which would result in the avoidance of a liability will not prevent its accrual. *Wien Consolidated Airlines, Inc. v. Commissioner*, 528 F.2d 735 (9th Cir. 1976); *Lawyers' Title Guaranty Fund v. United States*, 508 F.2d 1 (5th Cir. 1975); *Zwicker Knitting Mills v. United States*, 80-2 U.S. Tax Cas. (CCH) ¶ 9832 (Ct. Cl. 1980); *Buckeye International, Inc. v. Commissioner*, 49 Tax Ct. Mem. Dec. (CCH) 376, 382 (T.C. 1984).

The record clearly reflects that if HPI were to sell its business, the liability for the guaranteed jackpots would be provided for (J. A. 78) and that the probability of HPI closing its doors or the occurrence of the other similar contingencies suggested by the government are at best highly remote (Affidavit of Philip D. Griffith, J. A. 63). The government has conceded this to be the case (Pet. Br. 15). Further, the government's observation is inconsistent with its concession in its Reply Memorandum in the present case that remote contingencies such as bankruptcy do not preclude accruals under the all events test and its assertion that it was "not contending otherwise" (Pet. Reply Memorandum 3). Indeed, the government has stipulated that HPI cannot avoid payment of the guaranteed jackpot liability (J. A. 15-16; Pet. Br. 2). In

addition, as the Claims Court correctly points out, even if such a remote contingency did occur and the liability were avoided, the tax benefit rule would prevent HPI from obtaining any windfall which might otherwise occur by reason of the guaranteed jackpot liabilities not being paid (Pet. App. 15a). *See Putoma Corp. v. Commissioner*, 601 F.2d 734, 741 (5th Cir. 1979); *Alice Phelan Sullivan Corp. v. United States*, 381 F.2d 399 (Ct. Cl. 1967); Code § 61(a); Treas. Reg. § 1.461-1 (a)(2).

4. The government and the Ninth Circuit in *Nightingale* purport to rely on this Court's decision in *Brown v. Helvering*, 291 U.S. 193 (1934), to conclude that the guaranteed jackpot liability is contingent and thus cannot be accrued. By placing the guaranteed jackpot liability in a category with the type of liability involved in *Brown*, the government and the Ninth Circuit have completely misconstrued the nature of HPI's liability. The government observes that "[i]t often happens that a taxpayer is under a present obligation . . . to make specified future payments upon the happening of specified future events." (Pet. Br. 18). Based on this statement, the government contends that HPI's guaranteed jackpot obligations are contingent liabilities, which position it states is supported by this and other courts (Pet. Br. 18-21). What the government and the Ninth Circuit fail to recognize is that a contingent liability is one which is dependent on future events *which either may or may not occur*. HPI had a present liability, and the fact that such jackpots would be paid was certain not problematical. On the other hand, the occurrence of events giving rise to the liabilities in *Brown* and the other cases the government cites was speculative. In *Brown*, there was no certainty that insurance cancellations, which formed the basis for the accurals there, would ever oc-

cur because such cancellations were subject to the decision of the insureds. Similarly, in *Trinity Construction Co. v. United States*, 424 F.2d 302 (5th Cir. 1970), the liability to purchase life insurance for employees was dependent on the employees' survival until the due date for premium payments which either might or might not occur. In *Bennett Paper Corp. v. Commissioner*, 699 F.2d 450 (8th Cir. 1983), the liability for employee bonuses there accrued was dependent on the employees' continued employment in the following year. Likewise, in *World Airways, Inc. v. Commissioner*, 62 T.C. 786 (1974), *aff'd*, 564 F.2d 886 (9th Cir. 1977), the liability was dependent on the overhauls being performed, the contracts obligating the taxpayer to pay for the overhauls being subject to modification at any time by the parties. In the present case, it was certain that the guaranteed jackpots would be paid by virtue of the Gaming Regulations, the policies of the Board and the Commission, and the Nevada statutes. Determination of the time of payment and identity of the payee awaited only the winning play. The certainty, as contrasted to the indefinite nature of the obligations in the authorities relied on by the government, distinguishes those authorities and renders them not germane to this case.

5. The government characterizes the obligation of HPI for the guaranteed jackpots as analogous to an irrevocable offer, which is accepted by a winning play (Pet. Br. 21). If such characterization is correct, it is obvious that the "acceptance" of such "offer" occurs, not by a winning pull of the progressive slot machine handle, but by the gaming patron's investment of his funds with each play of the progressive slot machine in anticipation of winning the guaranteed jackpot (Affidavit of Jeffrey A. Silver, J. A. 75). Thus, when a machine is operated

on the casino floor, the so-called "irrevocable offer" would seemingly be deemed accepted with each play. Whether the play wins the guaranteed jackpot is irrelevant to the analogy because the presence of a profit or a financial return is not a requirement of a binding contract. This characterization would be entirely consistent with the holdings of the Federal Circuit and the Claims Court.

6. The government exhaustively urges on the Court that the Federal Circuit was improperly influenced in its decision by the coincidence of HPI's treatment of its guaranteed jackpot expense for federal income tax purposes with that required by financial accounting principles (Pet. Br. 21). There is nothing in the opinion of the Federal Circuit to suggest that such was the case. To the contrary, the Federal Circuit did hold, consistent with *Anderson's* view of the purpose of accrual tax accounting, that HPI's treatment of the deduction resulted in the accurate reflection of its taxable income and expense, thus avoiding, as the government urges, a result which would distort its taxable income (Pet. App. 2a). HPI has never contended, and does not now contend, that financial accounting principles should necessarily dictate the result in this case.

The basis of the government's argument is its view of the nature of the guaranteed jackpot liability as an "estimated future expense" or as a "contingent liability." (Pet. Br. 25). It illogically argues that, because financial accounting principles require that liabilities be accrued as soon as they can reasonably be estimated and because the Claims Court and the Federal Circuit permitted accrual of what the government views as an estimated expense, it must necessarily follow that

such courts were guided by financial accounting, and not tax accounting, principles in reaching their decisions. This same fallacious view—that the liability is contingent—has led the government to characterize the courts' sanctioning of the accrual as tantamount to permitting HPI to establish an unauthorized reserve for the liability because to not permit such an accrual would conflict with the matching principles of financial accounting (Pet. Br. 27). The government's reasoning seemingly is that, because in its view the liability is contingent or estimated and not fixed, the courts' decisions allowing its deduction must necessarily be based on financial accounting principles which permit a reserve for liabilities of that type to offset income. To permit such a reserve, it argues, would contravene the Congressional intent manifested in the repeal of Section 462 and violate the teaching of *Thor Power Tool Co.*, 439 U.S. 522. These arguments apparently find their genesis in the government's quotation of two sentences from the Federal Circuit's opinion (albeit in reverse order)[3] (Pet. Br. 22). These arguments completely disregard the holding of the Claims Court and the Federal Circuit that the guaranteed jackpots represent a "fixed liability" that "is not contingent." (Pet. App. 2a). Notably, there is no mention of financial accounting in the Federal Circuit's opinion. Thus the government, by prefacing its argument on the guaranteed jackpot liability being contingent, presumes the resolution of the issue before the Court rather than supporting its position. Such argument serves no purpose other than to confuse

3. The first sentence, in the sequence presented by the government, begins with the phrase "[Here,] the accounting method used by . . . ," and the second sentence begins with the phrase "If we were to require . . . ."

an otherwise straightforward matter—the satisfaction of the all events test by HPI's liability for guaranteed jackpots.[4]

7. The Ninth Circuit in *Nightingale* was concerned that the casino in that case was deducting an expense that was not being matched in the same taxable year with the income of a winning customer. The Ninth Circuit stated that "[a]nother factor of some significance is that the jackpots will not be taxable as income to any person until they are won." *Nightingale*, 684 F.2d at 615. No principle of federal income tax law dictates that a taxpayer may not deduct an accrued expense unless a corresponding amount of income is recognized at that time by another taxpayer. In fact, the recognition of the cash and accrual methods of accounting under Section 446(c) contemplates that there will be timing differences between the recognition of income by one party to a transaction who is on the cash method and the recognition of expense by the other party to the transaction who is on the accrual method. In a transaction between an accrual basis taxpayer and a cash basis taxpayer, the former is obligated to recognize expenses when the all events test is satisfied, while the latter must only report income actually or constructively received. Matching of income and expense between two different taxpayers is not required. Therefore, it is irrelevant to the outcome of this case that there is no

4. The government, without explanation, offers a summary of the economic performance requirement pertaining to the accrual of deductions, which was introduced by the Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 91(a), 98 Stat. 598-601 (adding Code Sections 461(h) and (i)). The government acknowledges that such requirement is not applicable to the years before the Court (Pet. Br. 29-30). Its reason for this summary is unclear. Perhaps it intends to imply that HPI could not satisfy the economic performance test imposed by the new legislation; however, such a suggestion serves as a tacit admission that there is no support in *applicable law* for the result it seeks in the present case.

matching of income and expense between HPI and its customers.

8. Finally, the government contends, again based on the Ninth Circuit's attempt in *Nightingale* to support its decision, that the allowance of the deduction for the guaranteed jackpots would open the way "for casinos to overcome the restraints of annual accounting in a perfectly legal way. They could put extra machines on the floor on the last day of the tax year with whatever initial jackpot they chose and with whatever odds they liked. Then they could take a current deduction for the full amount even though payment of the jackpots might not occur for many years." (Pet. Br. 32). There was no suggestion that such tax avoidance occurred in *Nightingale,* and the government admits that such an abuse has not occurred in the present case (Pet. Br. 32).

The theoretical manipulability, which the government contends is inherent in HPI's treatment of the guaranteed jackpot expense, ignores (1) the random method by which such jackpots are determined; (2) the practical restraints imposed by industry competition which demand that realistic gaming opportunities be offered; and (3) the immateriality of the expense in the determination of HPI's gaming income. The government suggests that the time value of the accruals provides an incentive for manipulation to occur because, the government says, "their time value alone, as this case demonstrates . . . can involve huge amounts of revenue." (Pet. Br. 31). The aggregate amount of tax involved in this case is some $434,000 for four years, with the largest amount of tax in any one year totalling approximately $173,000 (J. A. 3). The discounted value of this amount would hardly be a "huge amount" in the context of HPI's

financial condition, particularly considering that the average period between payment of guaranteed jackpots was only 4½ months (J. A. 62).

Assuming, *arguendo,* that there were a legitimate basis in fact for such a concern about such manipulations, it would be resolved by Code Section 446(b) which provides that "[i]f the method used [to compute taxable income] does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income." In any case where it can be demonstrated that an abuse has occurred, the Commissioner has authority under Section 446 to modify a taxpayer's accounting method to insure a clear reflection of income. *See Commissioner v. Hansen,* 360 U.S. 446, 467 (1959); *Lucas v. American Code Co.,* 280 U.S. 445, 449 (1930); *Clement v. United States,* 580 F.2d 422 (Ct. Cl. 1978), *cert. denied,* 440 U.S. 907 (1979). Therefore, although the government concedes that no distortion of taxable income resulted in *Nightingale* or in HPI's case (Pet. Br. 32), a court could disallow a deduction if such abuse were shown to have occurred.

CONCLUSION

For the reasons stated above, the decision of the United States Court of Appeals for the Federal Circuit should be affirmed.

Respectfully submitted,

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February 28, 1986